SUPREME COURT, U.S.
FILED
NOV 22 1993
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No. 93-339

In The

Supreme Court of the United States

October Term, 1993

JAMES W. BURKE, as Personal Representative of the ESTATE OF EDNA SPROULL WILLIAMS, Deceased,

Petitioner,

vs.

THE UNITED STATES,

Respondent.

On Petition For Writ Of Certiorari To The United States Court Of Appeals For The Federal Circuit

REPLY BRIEF FOR PETITIONER

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PRELIMINARY STATEMENT

Petitioner, in filing the Petition for a Writ of Certiorari with the Court and in connection with the Respondent's Brief in Opposition and this Brief in reply, is fully cognizant of the fact that the primary focus of the Petition is not to discuss in any details the merits or demerits of Petitioner's case or the Opinion of the Court of Appeals, but instead to focus and call to the attention of the Court and its personnel that the basis for jurisdiction of the Supreme Court is to resolve what we believe to be an absolute and irreconcilable conflict between the Opinion of the Fifth Circuit in *Estate of Dorothy J. Warren, Dec. v. Commissioner*, 981 F.2d 776 (5th Cir. 1993) and the decision of the Court of Appeals.

The issue involved is to whether or not a taxpayer is required to reduce the amount of a charitable deduction allowable under Section 2055 of the Code and/or the marital deduction provided by Section 2056 for estate tax purposes in a situation where post-mortem administrative expense accumulations were paid from post-mortem accumulated income, and that no portion of these expenses were paid from the principal or corpus of the decedent's estate.

The Court of Appeals for the Fifth Circuit in the *Warren* case unequivocally held that the payment of post-mortem administrative expenses from accumulated estate income *does not reduce* either the amount of the allowable charitable deduction or marital deduction for federal estate tax purposes.

The decision of the Court of Appeals in this case is directly and absolutely contrary to the decision in *Warren*, wherein the Court of Appeals concluded that it was legally permissible for the Commissioner to reduce the amount of the estate's charitable deduction, otherwise allowed by Section 2055, by the amount of the post-mortem administrative accumulated expenses and associated interest, whether or not these expenses were paid from estate principal or accumulated income.

This is the basis and only basis for which we seek review by the Supreme Court of Petitioner's case and the Opinion of the Court of Appeals.

The comments that appear hereinafter in this Brief have been made to point up and bring into sharper focus the conflict between the two decisions and also the developing conflict between the recent decisions of the Tax Court of the United States and several other appellate cases involving this issue.

ARGUMENT

Petitioner in reply to the contentions contained in the Brief of Respondent in Opposition to the Petition, submits the following:

1. The Respondent at Paragraph 1, Page 6 of its Brief in Opposition alleges that administrative expenses are chargeable against the gross estate regardless of their source of payment, citing Section 2053(a) of the Code, that provides the general rules that states "the value of the taxable estate shall be determined by deducting from the value of the gross estate" the amount of funeral expenses, administrative expenses, claims against the estate and unpaid mortgages.

It is Petitioner's contention that this case does not directly involve Section 2053(a) of the Code but instead involves the proper construction of Section 2055, which provides for the deduction of all charitable bequests from the value of the decedent's gross estate, in order to determine the net estate, upon which the estate tax is levied.

Respondent also states that "Income received by an estate during its administration ('post-mortem income') is not included in the gross estate for estate tax purposes."

We quite agree with this observation and point out to the Court that there is absolutely no contention that the estate's post-mortem income should be includable in the decedent's gross estate, either directly or indirectly.

The sole issue raised in the Petition is whether or not there is a conflict between the Opinion of the Court of

Appeals and the Decision of the Fifth Circuit in *Estate of Dorothy J. Warren, Dec. v. Commissioner*, 981 F.2d 776 (5th Cir. 1993).

The conflict between these two decisions arises essentially as follows:

The Court of Appeals in this case held that the estate's charitable deduction, under Section 2055, must be reduced by the amount of the post-mortem accruing administrative expenses, whether or not they were paid from post-mortem income accumulations or the principal of the estate on hand at date of death.

The Fifth Circuit in *Warren* held directly to the contrary and respected a stipulation of the parties, pursuant to which 72 1/2% of the post-mortem administrative expenses were allocated to or paid from post-mortem income accumulations, and that by reason of this action, the Court held that the charitable deduction available to the estate was *not* reduced by the payment of administrative expenses from accumulated estate's income, as contended by the Commissioner.

We submit, therefore, that there is an irreconcilable conflict between the decision of the Court of Appeals and the decision of the Fifth Circuit in *Warren*.

On Page 7 of Respondent's Brief, there is a partial quotation from Senate Committee Report No. 1013, 80th Cong., 2d Sess. Pt. 2, at 6 (1948) wherein it is stated, " . . . *if the estate income is used to pay, claims so as to increase the residue,* such increase in the residue is acquired by purchase and not by bequest. Accordingly, the value of any such additional part of the residue passing to the surviving spouse cannot be included in the amount of the marital deduction."

We wish to point out to the Court that the above Committee Report refers only to "claims" against the estate and in no place mentions post-mortem accumulations of administrative expenses.

Later in this Brief, we will develop more fully the difference in estate tax treatment between claims against

the estate and post-mortem accumulated administrative expenses.

2. The Respondent in Paragraph 2, Page 8 of its Brief, contends that the Court of Appeals correctly rejected Petitioner's contention that the charitable deduction under Section 2055 should be based upon the actual distributions to the Foundation.

Petitioner has never contended that the amount of the charitable deduction allowable under Section 2055 should be increased by one cent of the estate's post-mortem income accumulations.

Petitioner agrees that the charitable deduction is geared to the value of the decedent's estate on hand at date of death, and that post-mortem income accumulations do not either increase or decrease the amount of the allowable deduction.

The point in the case is that since the controversial administrative expenses were shown to have been paid from post-mortem income accumulations, then there is no way that it can logically be said that the decedent's gross estate has been diminished by the payment of administrative expenses, and to the contrary, the charitable donee received from the principal of the decedent's estate on hand at date of death, an amount of property exactly equal in amount to the charitable deduction taken on the estate tax return under Section 2055.

The only purpose for which Petitioner tabulated the total payments made from the decedent's estate to the Foundation was to show that the charitable legatee received from the principal of the decedent's estate, an amount of property not less in value than the charitable deduction claimed under Section 2055. Additionally, the tabulation was made to show that the charitable donee received a great deal more in property than the amount of the charitable deduction claimed on the estate tax return (Form 706).

3. The Respondent at Paragraph 3, Page 8 of its Brief eludes to the fact that "The court of appeals did not

err in disregarding the unopposed Florida probate court order that allowed petitioner to pay administrative expenses from post-mortem income."

We submit that entirely too much emphasis is being placed by Respondent on the question of the source of the authority pursuant to which Petitioner's Personal Representatives admittedly paid certain post-mortem accumulated administrative expenses from post-mortem accumulated income. The point in the case is that the Personal Representatives did in fact pay the administrative expenses from post-mortem income and, therefore, none of these payments had the effect of reducing the amount of the decedent's gross or net taxable estate and, therefore, the amount of the charitable deduction should not be reduced, as determined by the Commissioner and affirmed by the Court of Appeals.

4. The Respondent in Paragraph 4, Page 9 of its Brief makes the positive statement that "The decision in this case does not conflict with *Estate of Warren v. Commissioner* . . . "

We urge the Court to reject this contention, since we earnestly feel that any fair objective reading of the Opinion of the Fifth Circuit in *Warren* makes it crystal clear that where a portion of the estate's post-mortem administrative expenses are paid from post-mortem income accumulations, the estate is not bound, as a matter of law, to reduce the amount of the marital or the charitable deduction otherwise allowable to the estate for federal estate tax purposes.

Admittedly, *Warren* arose under a different factual pattern than Petitioner's case, but the underlying legal principle, as it relates to the issue, we submit, is identical.

We urge the Court to grant this Petition, so that this conflict between the Court of Appeals and the Fifth Circuit can be resolved, once and for all.

5. Respondent, at Page 11 of its Brief cites the case of *Estate of Gordon P. Street v. Commissioner*, 974 F.2d 723 (6th Cir. 1992).

The Sixth Circuit reversed the Tax Court and " . . . held that the marital deduction is reduced by administrative expenses paid from either principal or income, . . . " but at the same time, interestingly enough, the Court went on to hold that post-mortem interest accumulations do not reduce the amount of the marital deduction or, for that matter, the charitable deduction.

Respondent states "Interest expense is treated differently because it accrues after death; estate income used to pay that expense therefore would not affect the size of the gross estate."

To further point out the absurdity of the Respondent's position in this case, the uncontradicted facts show that all of the administrative expenses, just as interest expense in the *Street* case, arose and were accumulated after the decedent's death and did not constitute any type of claim against the decedent's estate at time of death and, that all of the administrative expenses involved in this case were paid from the estate's accumulated income and, therefore, again do not affect the size of the decedent's gross estate.

We, therefore, contend that the payment of post-mortem administrative expenses, just as post-mortem interest expense in *Street*, does not affect the size of the decedent's gross estate and hence, these payments do not reduce the amount of the charitable deduction allowable to the estate under Section 2055.

6. Since the filing of the Petition in this case, the Tax Court of the United States has rendered two very significant decisions involving the issue directly involved in this case and should, we think, be properly brought to the attention of the Court.

The first of these cases is *Estate of Otis C. Hubert, Dec. v. Commissioner*, T.C. Docket No. 22333-90, 101 T.C. No. 22, filed October 19, 1993.

The Tax Court in *Hubert* held that an estate was not required to reduce its marital and charitable deductions by the amount of estate administrative expenses paid out

of estate income. In so holding, the Tax Court expressly declined to follow the decision of the Court of Appeals in *Street* and also expressly declined to follow the decision of the Court of Appeals in this case.

Contrary to the Court's decision in *Street*, the Tax Court in *Hubert* concluded that Treasury Regulation Section 20.2056(b)-4(a) did not mandate a set-off against the marital deduction for administrative expenses allocated to income. According to the Tax Court, that Regulation is merely a valuation provision that requires material limitations on the right to receive income to be taken into account when valuing the property interest passing to a surviving spouse.

Moreover, the Court noted that the Legislative history of Section 20.2056, which indicates that *"claims against the estate would reduce a marital deduction but was not applicable to administrative expenses"*.

According to the Tax Court, there is a clear distinction between claims against an estate, which are in existence at the date of the decedent's death and relate to corpus, and administrative expenses, which come into existence only after the date of the decedent's death and can logically be charged either to income or corpus.

Therefore, we find that the Tax Court, a trial court of nationwide jurisdiction, has expressly refused to follow the decision in *Street* and also has refused to follow the decision in this case, rendered by the Court of Appeals, as it relates to the issue directly involved.

Petitioner has attached as Appendix "A" all of the Opinion of the Tax Court in the *Hubert* case, except that the two dissenting and concurring opinions have been intentionally omitted. As the Court will see from Appendix "A", the *Hubert* case was reviewed by the full Tax Court and two of the judges filed dissenting and concurring opinions.

The Tax Court in *Hubert*, in expressly declining to apply the decision of the Court of Appeals in this case

and the decision of the Sixth Circuit in *Street*, stated (Appendix A, *infra* p. 22a):

> Thus, the Court of Appeals concluded that payment of administration expenses from income of the estate should reduce the marital deduction, but payment of interest on estate and inheritance taxes from income should not reduce the marital deduction. See also *Burke v. United States* [93-1 USTC Section 60,132], 994 F.2d 1576 (Fed. Cir. 1993), and *Fisher v. United States*, 28 Fed. Cl. 88 (1993), which rely on the rationale of *Estate of Street* with respect to administration expenses.
>
> Respectfully, we disagree with the reasoning of the Court of Appeals and decline to follow its decision in *Estate of Street*.

Both the dissenting and concurring opinions of Judge C. J. Hamblen and Judge J. Halpern in *Hubert* cited and commented briefly on the Court of Appeals Opinion in this case.

The Tax Court rendered a second Opinion involving this issue in *Estate of Frances Blow Allen v. Commissioner*, T.C. Docket No. 309-91, 101 T.C. No. 23, filed October 20, 1993. The Tax Court, in *Allen*, held that the marital trust there involved should not be reduced by the amount of administrative expenses paid from other sources and expressly declined to follow the decision of the Sixth Circuit in *Street*.

Petitioner has attached as Appendix "B" Commerce Clearinghouse's Digest, *Federal Estate and Gift Tax Reports*, Number 226, dated October 26, 1993, reporting of the Decision of the Tax Court in *Allen*.

Counsel for Petitioner is fully aware that the Supreme Court does not ordinarily resolve conflicts between Federal Trial Courts and the various Courts of Appeal.

We have cited both the *Hubert* and *Allen* cases to simply show to the Court the continual litigation of the issue involved in this case and what we think is the practical necessity of the Court's granting this Petition, so

as to resolve the conflict between the decision of the Court of Appeals and the decision of the Fifth Circuit in *Warren*.

CONCLUSION

Petitioner respectfully suggests to the Court that the Petition filed in this case should be granted, so that the direct conflict between the Opinion of the Court of Appeals and the Opinion of the Fifth Circuit in *Warren* can be resolved, once and for all, in order to resolve a point of federal estate taxation, which has been a recurring one over a period of many years.

Because of the continuous and regularity with which the issue involved in this case is and has been litigated, we are somewhat puzzled, as to why Respondent has elected not to agree to the Court's granting the Petition, in order to resolve the conflict and the multiplicity of cases that have arisen involving this issue and which continue to be litigated, even to the present time.

We therefore urge the Court to grant the Petition.

Respectfully submitted,

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Dated November 22, 1993

"APPENDIX A"

[CCH Dec. 49,342] Estate of Otis C. Hubert, Deceased, C&S/Sovran Trust Company (Georgia), N.A., A National Banking Association, Co-Executor, v. Commissioner.

Docket No. 22333-90. 101 TC ___, No. 22. Filed October 19, 1993. [Appealable, barring stipulation to the contrary, to CA-11. – CCH.]

[*Code Secs. 642, 2055 and 2056*]

[Estate tax: Marital and charitable deductions: Property passing to surviving spouse and charity: Settlement agreement.] Pursuant to a good faith settlement of a will contest alleging undue influence, decedent's 1982 will and codicils thereto were amended to provide, inter alia, for the division of the residuary estate into marital and charitable portions with the allocation of principal, accumulated income, and expenses to each.

Held: The amounts passing to the marital and charitable shares are those in the settlement agreement and are not limited to the amounts which would have passed under the 1982 will and codicils.

Held, further, the marital and charitable deductions are to be reduced only by the portion of administration expenses allocated to principal and not by amounts allocated to income. *Estate of Street v. Commissioner* [92-2 USTC ¶ 60,112], 974 F.2d 723 (6th Cir. 1992), affg. in part, revg. in part and remanding [Dec. 45,201(M)] T.C. Memo. 1988-553, not followed.

Held, further, the marital and charitable portions are not to be reduced by imputed income at the rate of 7 percent per annum; the marital and charitable deductions are valued at the date of death and only appropriate charges to principal will reduce the deduction.

David W. Aughtry, and James M. McCarten, 233 Peachtree St., N.E., Atlanta, Ga., for the petitioner. Willard N. Timm, Jr., for the respondent.

Opinion

CLAPP, Judge: Respondent determined a deficiency in petitioner's estate tax in the amount of $14,052,146. After concession by the parties, the remaining issues for decision are: (1) Whether the amounts of petitioner's marital and charitable deductions are limited to the amounts passing to the marital and charitable shares under the 1982 will and three codicils, or are the amounts actually passing under a settlement agreement to the marital and charitable shares as reduced by obligations charged to the respective shares; (2) whether the amounts of the marital and charitable deductions must be reduced by administration expenses paid from the marital and charitable portions[1] under the settlement agreement, without regard

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[1] We are using the terms "marital portion" and "charitable portion" to mean the amounts received by the spouse and the charity, respectively, under the settlement agreement. Pursuant to the settlement agreement, the marital and charitable portions include income accumulated to the date of distribution. The terms "marital portion" and "charitable portion" should not be confused with the terms "marital share" and "charitable share" or "marital deduction" and "charitable deduction".

to whether the estate allocated those expenses to income; and (3) whether the marital and charitable portions must be discounted by 7 percent per annum to take into account income deemed to be earned by the residue.[2]

This case was submitted fully stipulated under Rule 122. We incorporate by reference the stipulation of facts and attached exhibits. All section references are to the Internal Revenue Code as in effect at the date of decedent's death, and all Rule references are to the Tax Court Rules of Practice and Procedure.

Petitioner is the Estate of Otis C. Hubert (decedent). Decedent was a resident of Marietta, Georgia, when he died on June 2, 1986. C&S/Sovran Trust Company (C&S) is the coexecutor of decedent's estate. On the date the petition was filed, C&S had its principal place of business in Atlanta, Georgia.

At the time of his death, decedent was married to Ruth S. Hubert (Mrs. Hubert). The Huberts had four children: Richard N. Hubert, Marilyn Hubert Kemper, Judith Hubert Manning, and Deborah Hubert Jones.

In January 1982, decedent executed the last will to be signed prior to his death (the 1982 will). That will superseded his previous will, which had been executed in 1977.

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[2] The Court has severed, for decision in a separate opinion, *Estate of Hubert v. Commissioner* [Dec. 49,345(M)] T.C. Memo. 1993-482, the issue of whether bequests in the amount of $100,000 each to two subtrusts providing for the support of the missionary work of charitable organization through two named individuals and for the establishment of foreign mission field medical clinics qualify for a charitable deduction.

The 1982 will was modified three times by codicils executed between February 4, 1982, and June 8, 1983. Decedent's nephew, Robert H. Owen (Owen), drafted the will and the three codicils.

In addition to certain specific bequests, the 1977 will left, in trust, an amount equal to the maximum marital deduction; however, if the estate tax due from the estate (before application of any credits) were less than any credits available to the estate, the marital bequest was to be reduced to that amount which would cause the estate tax owed by decedent's estate (before application of any credits) to equal the total of all credits finally allowed. Decedent's intent was to fully utilize all credits and deductions. The income from the trust was payable to Mrs. Hubert for her life, with the remainder to charity. Mrs. Hubert had a general power of appointment over the trust. The 1977 will also established a charitable remainder unitrust from the residue of the estate. The trustee had the discretion to distribute 5 percent of the net assets of the charitable trust annually to Mrs. Hubert or any of the Hubert children. Upon the death of Mrs. Hubert, the charitable trust terminated, and the remainder was to be distributed outright to charity.

The 1982 will left the residue of decedent's estate in trust, the income of which was to be paid to Mrs. Hubert, with the remainder to charity. Mrs. Hubert had a general power of appointment. The second codicil to the 1982 will eliminated Mrs. Hubert's general power of appointment.

Upon decedent's death, will contests were filed by various members of the Hubert family, including Mrs. Hubert. The will contest instituted by Mrs. Hubert

requested the Probate Court to strike the second codicil to the 1982 will or, in the alternative, to strike the 1982 will and all the codicils, because of alleged undue influence by Owen in favor of the charitable remainder beneficiaries. In June 1987, the Hubert family, Owen, and the district attorney for Cobb County, Georgia, where the will was being probated, entered into an "Agreement of Interested Parties" (the first agreement), which purported to resolve all of the differences among the competing interests under the will.

The Georgia revenue commissioner challenged the first agreement alleging that he was a necessary party to ensure that the charitable beneficiaries were treated fairly. As a result of negotiations, which included the Georgia revenue commissioner and the Georgia attorney general as representatives for the charities, the first agreement was supplanted by the "Second and Final Settlement Agreement" (settlement agreement) on October 10, 1990, which was approved by the Superior Court of Cobb County in an Order, Judgment, and Decree. The Cobb County Probate Court entered a final order adopting the Order, Judgment, and Decree as binding in its proceedings on November 28, 1990.

The settlement agreement amended the 1982 will and codicils by deleting item VIII, which disposed of the residuary estate, and all codicil provisions related to that item. In lieu thereof, the settlement agreement added various provisions, including provisions for the division of the residuary estate between the marital and charitable portions and for the allocation of expenses between the marital and charitable portions. Under the settlement agreement, Mrs. Hubert was named beneficiary of a part

of the residue in two trusts: The marital trust, over which she had a general power of appointment, and the QTIP trust. The charity received the rest of the residue outright.

Based on the first agreement, an estate tax return, Form 706, was filed on September 2, 1987. Respondent issued a notice of deficiency on August 31, 1990, disallowing $12,650,592 of the marital deduction and $12,502,655 of the charitable deduction, as well as making adjustments to the deduction for debts of the decedent and to the amount of adjusted taxable bequests.

Limitations on Deductions Based on the 1982 Will and Codicils

The first issue for decision is whether the marital and charitable deductions are limited by the amounts Mrs. Hubert and the charity would have taken under the 1982 will and codicils.

Marital Deduction

Section 2056(a) provides in pertinent part:

> For purposes of the tax imposed by section 2001, the value of the taxable estate shall . . . be determined by deducting from the value of the gross estate an amount equal to the value of any interest in property which passes or has passed from the decedent to his surviving spouse, but only to the extent that such interest is included in determining the value of the gross estate.

In defining whether an interest in property has "passed from the decedent to his surviving spouse" in the context

of a will contest, section 20.2056(e)-2(d)(2), Estate Tax Regs., states:

> If as a result of the controversy involving the decedent's will, or involving any bequest or devise thereunder, a property interest is assigned or surrendered to the surviving spouse, the interest so acquired will be regarded as having "passed from the decedent to his surviving spouse" only if the assignment or surrender was a bona fide recognition of enforceable rights of the surviving spouse in the decedent's estate. Such a bona fide recognition will be presumed where the assignment or surrender was pursuant to a decision of a local court upon the merits in an adversary proceeding following a genuine and active contest. However, such a decree will be accepted only to the extent that the court passed upon the facts upon which deductibility of the property interests depends. If the assignment or surrender was pursuant to a decree rendered by consent, or pursuant to an agreement not to contest the will or not to probate the will, it will not necessarily be accepted as a bona fide evaluation of the rights of the spouse.

Respondent argues that petitioner's marital deduction is limited to the lesser of the amount distributed to Mrs. Hubert under the settlement agreement or the amount that would have been so distributed under the 1982 will and codicils. Presumably, respondent's contention is that Mrs. Hubert did not have an enforceable right in decedent's estate to any amount in excess of what she would have received under the 1982 will and codicils.

Petitioner argues that "(i) a good faith compromise of (ii) a *bona fide* will dispute, (iii) involving uncontested provisions of state law, is absolutely dispositive of the question of enforceable rights." Petitioner contends that, although a settlement agreement cannot definitively determine questions of law, it can conclusively resolve questions of fact. Petitioner concludes that, since the State law in this case is clear and the dispute is inherently factual, the settlement agreement should control.

In deciding whether a settlement agreement is a "bona fide recognition of enforceable rights of the surviving spouse in decedent's estate", this Court has looked to whether the agreement was made in good faith as the result of arm's-length negotiations. *Estate of Barrett v. Commissioner* [Dec. 20,406], 22 T.C. 606, 611 (1954).

However, in *Commissioner v. Estate of Bosch* [67-2 USTC ¶ 12,472], 387 U.S. 456 (1967), the Supreme Court held that a Federal court deciding the estate tax consequences of an attempted disclaimer was not bound by the State trial court's adjudication of the property rights involved. Citing *Erie R. Co. v. Tompkins*, 304 U.S. 64 (1938), the Court noted that "state law as announced by the highest court of the State is to be followed." *Commissioner v. Estate of Bosch, supra* at 465. Moreover, the Court explained that the State's intermediate appellate court decisions should be considered in deciding State law unless the Federal court is convinced that the highest court of the State would rule otherwise. Therefore, the Court concluded that a Federal court may not always be bound by the decision of the intermediate appellate court and that "when the application of a federal statute is involved, the decision of a state trial court as to an

underlying issue of state law should a fortiori not be controlling." *Id.* Finally, the Court explained:

> the underlying substantive rule involved is based on state law and the State's highest court is the best authority on its own law. If there be no decision by that court then federal authorities must apply what they find to be the state law after giving *"proper regard"* to relevant rulings of other courts of the State. In this respect, it may be said to be, in effect, sitting as a state court. [*Id.*; emphasis added; citation omitted.]

In light of the Supreme Court's decision in *Estate of Bosch*, courts have concluded that if the decision of a State trial court on a matter of State law is not binding for estate tax purposes, a good faith settlement of such an issue cannot be either. *Ahmanson Found. v. United States* [81-2 USTC ¶ 13,438], 674 F.2d 761, 774 (9th Cir. 1981). We agree. In deciding whether the surviving spouse has enforceable rights in decedent's estate, courts must look behind any settlement agreement to ensure that the claim on which it is based is valid. *Estate of Brandon v. Commissioner* [87-2 USTC ¶ 13,733], 828 F.2d 493, 499 (8th Cir. 1987), revg. and remanding [Dec. 42,911] 86 T.C. 327 (1986).

While we agree that we are not bound by the settlement agreement for our decision of Mrs. Hubert's enforceable rights, we conclude that the agreement should not be ignored here. We have looked at the adversarial or nonadversarial nature of the proceedings in the State courts to determine the weight to be given such settlement agreements. See *Estate of Sawyer v. Commissioner* [Dec. 36,371], 73 T.C. 1 (1979) (Tax Court followed the

decision of the Court of Appeals of Ohio because the decision was the result of a bona fide adversary proceeding, and the Court could not conclude that the Supreme Court of Ohio would not follow the lower court decision); *Harrah v. Commissioner* [Dec. 35,358], 70 T.C. 735, 754 (1978) (Tax Court followed the characterization of property in a settlement agreement approved by a Nevada divorce court because the Court believed "the Nevada Supreme Court would have approved the action taken by the divorce court had it been called upon to review it", emphasizing the adversarial nature of the settlement); *Estate of Rowan v. Commissioner* [Dec. 30,025], 54 T.C. 633 (1970) (Tax Court disregarded the determination of property ownership made by the Superior Court of California where it was not the result of bona fide adversary litigation and made an independent determination of the facts and law).

The parties have stipulated that the settlement agreement was the result of a bona fide adversary proceeding. Under the settlement agreement, Mrs. Hubert received in value more than half of what she would have received if she had succeeded in having the second codicil declared invalid as the product of undue influence and substantially all of what she would have received if she had succeeded in having the 1982 will and codicils declared invalid as the products of undue influence. Moreover, this was a settlement among adverse parties with significant interests to protect in the litigation, including the Georgia attorney general and the Georgia revenue commissioner, whose right to participate in the litigation was litigated all the way to the Supreme Court of Georgia. The settlement agreement also was approved by the

Superior Court of Cobb County. Under Georgia law a settlement agreement sustaining a will challenge can be approved by the Superior Court only "after a hearing, notice of which shall be given as the court shall direct, at which evidence is introduced and at which the judge finds as a matter of fact that the caveat is meritorious." Ga. Code Ann. sec. 53-3-22(a) (Michie 1982).

In addition, this is not a circumstance in which respondent's interests were hurt by the compromise reached by the parties. If the probate of the estate had proceeded without challenge, and the estate tax return had been filed based on the 1982 will and codicils, Mrs. Hubert would have been entitled to an income interest for life, payable at least annually, in the entire residue of the estate. Therefore, petitioner could have made a QTIP election and been entitled to a deduction for the entire residue. We note that respondent has conceded that the second settlement agreement modified the 1982 will and codicil so that section 2056(b)(7)(B)(i)(III) does not bar the marital deduction. Since the estate would have been entitled to a full deduction for the residue under the 1982 will and codicils, there is no way that the parties could have acted in a manner contrary to respondent's interests.[3]

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[3] We note that the additional tax that would arise if respondent prevailed on this argument is the result of the inconsistent treatment given to settlement agreements in the regulations. If Mrs. Hubert did not have an enforceable right to all of what she received under the settlement agreement, petitioner would be entitled to deduct only the amount she would have received under the 1982 will and codicils. The rationale for the result is that any amount to which she did not have an enforceable right did not pass to her from decedent, but was given to her by the

Taking all of the circumstances surrounding the settlement agreement into consideration, we are convinced that what Mrs. Hubert received under the settlement agreement is in satisfaction of enforceable rights in decedent's estate. Although the regulations state that the settlement agreement will not *necessarily* be accepted as a bona fide evaluation of such rights, they do not require rejection of such settlement agreement. In this instance we think it is appropriate to recognize the amounts passing to Mrs. Hubert under the settlement agreement as passing from decedent, especially in the absence of any suggestion that the settlement agreement was entered into for post mortem tax planning purposes.

Therefore, we hold that the marital deduction is not limited by the amount Mrs. Hubert would have taken under the 1982 will as amended by the second codicil.

Charitable Deduction

Respondent argues that the charitable deduction also is limited to the lesser of the amount the charity would have received under the 1982 will and codicils or the

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charity in exchange for dropping her challenge. However, under the regulations, petitioner is not entitled to a charitable deduction for the amount the charity gave up in the settlement, presumably because if the charity never actually received the property before giving it up, it was not a bequest, legacy, devise, or transfer to or for the use of a charitable organization. Consequently, if Mrs. Hubert did not have an enforceable right to all of the amount she received under the settlement, a portion of the residue which was left entirely to either Mrs. Hubert or the charity would be treated as having passed to neither of them.

amount it actually received under the settlement agreement. Petitioner argues that the charitable deduction is equal to the amount the charity actually received provided the settlement was not collusive. We note that the parties appropriately agree that "the Second Settlement Agreement modified the 1982 Will and three Codicils so that the split interest provisions under I.R.C. section 2055(e) [do] not bar a deduction for the charitable gift". See *Flanagan v. United States* [87-1 USTC ¶ 13,718], 810 F.2d 930 (10th Cir. 1987); *First Natl. Bank v. United States* [84-1 USTC ¶ 13,558], 727 F.2d 741 (8th Cir. 1984); *Estate of Strock v. United States* [87-1 USTC ¶ 13,717], 655 F. Supp. 1334 (W.D. Pa. 1987); *Northern Trust Co. v. United States*, 41 AFTR 2d 78-1523, 78-1 USTC ¶ 13,229 (N.D. Ill. 1977); Rev. Rul. 89-31, 1989-1 C.B. 277. Therefore, the parties agree that petitioner is entitled to some amount of charitable deduction. Moreover, since the charity will receive less under the settlement agreement than it would have received under the will, respondent and petitioner are in agreement that the settlement agreement controls the amount of the charitable deduction.

Allocation of Expenses

The second issue for decision is whether the marital and charitable deductions must be reduced by expenses allocated to income of the estate.

The 1982 will gave the executors of decedent's estate the power "to charge any expenses against income or principal or apportion the same". The executors allocated $506,989 as funeral and administration expenses to the

principal of the estate. All other administration expenses were allocated to income.

Respondent argues that the amount of a marital or charitable deduction must be reduced by the entire amount of administration expenses, whether those expenses are allocated to principal or to income. Respondent cites section 20.2056(b)-4(a), Estate Tax Regs., and the legislative history of section 2056 as support for the proposition. In addition, respondent argues that the courts have "uniformly recognized" that administration expenses reduce the marital and charitable deductions regardless of whether those expenses are paid out of income or principal. Respondent contends that both Georgia law and the language of the settlement agreement also mandate such a result. We disagree.

Before considering this issue in detail, it is helpful to consider an overview of the operation of estate accounting and estate taxes. The starting point for determining Federal estate taxes is the date-of-death (or alternate valuation date) value of the property of the estate. Deductions are allowed for various expenses of the estate, as well as for claims against the estate and bequests to the decedent's spouse and to charity. Income earned by the estate has no effect on the estate for Federal estate tax purposes. It is accounted for separately in the estate's probate account and is taxed separately on the estate's Forms 1041.

Executors have been granted significant flexibility in accounting for the estate's administration expenses, both for estate and income tax purposes, and for probate accounting purposes. Congress has granted the executor

the option of deducting administration expenses on either the estate return, Form 706, or the fiduciary income tax return, Form 1041. Sec. 642(g). In addition, many States give the decedent the option of authorizing the executor to allocate such expenses to principal or to income at the executor's discretion. If the administration expenses were paid out of principal, they would reduce the amount of such principal received by the beneficiaries and would reduce the marital and charitable deductions. However, we conclude that the administration expenses that are allocable to income in this case do not change the amount of the estate principal received by the spouse or the charity and do not reduce the marital and charitable deductions. Administration expenses are incurred and accrue during administration and should not be confused with claims against the estate which existed and accrued at the date of death.

Our conclusion that the marital and charitable deductions are not reduced by payment of administration expenses allocated to income does not lead to a double deduction in violation of section 642(g). Section 642(g) prohibits a deduction under section 2053 or 2054 for any administration expenses deducted on the estate's income tax return. However, section 642(g) does not prohibit or reduce deductions under section 2055 or 2056. The deductions under sections 2055 and 2056 are based on the date-of-death value of the property received by the charity and the spouse from the gross estate. The executor's ability to preserve the value of the marital and charitable bequests by allocating administration expenses to income is in no way barred by section 642(g).

The allocation of the expenses in the case before us is governed by Georgia law. Georgia law authorizes allocation of expenses to income rather than principal, if provided in the will. Ga. Code Ann. secs. 53-2-101, 53-15-3 (Michie 1982). The 1982 will authorized such an allocation, and this provision was not affected by the settlement agreement. To the extent the executor exercised its discretion and allocated administration expenses to income, the marital and charitable deductions are not reduced by payment of those expenses.

Respondent argues that section 20.2056(b)-4(a), Estate Tax Regs., controls this question. That section states, in relevant part:

> Marital deduction; valuation of interest passing to surviving spouse. – (a) *In general.* * * * The marital deduction may be taken only with respect to the net value of any deductible interest which passed from the decedent to his surviving spouse, the same principles being applicable as if the amount of a gift to the spouse were being determined. *In determining the value of the interest in property passing to the spouse* account must be taken of the effect of any material limitations upon her right to income from the property. An example of a case in which this rule may be applied is a bequest of property in trust for the benefit of the decedent's spouse but the income from the property from the date of the decedent's death until distribution of the property to the trustee is to be used to pay expenses incurred in the administration of the estate. [Emphasis added.]

We do not interpret section 20.2056(b)-4(a), Estate Tax Regs., as mandating a setoff against the marital deduction

for administration expenses allocable to income. That section is merely a valuation provision which requires material limitations on the right to receive income to be taken into account when valuing the property interest passing to the surviving spouse. The fact that income from property is to be used to pay expenses during the administration of the estate is not necessarily a material limitation on the right to receive income that would have a significant effect on the date-of-death value of the property of the estate.

On the facts before us, we find that the trustee's discretion to pay administration expenses out of income is not a material limitation on the right to receive income. Under section 2056(b)(4) and section 20.2056(b)-4(a), Estate Tax Regs., the value of the interest passing to the spouse and the effect of any encumbrance on that interest shall be determined "as if the amount of a gift to the spouse were being determined." Therefore, we look to the gift tax provisions and consider how they treat the payment of expenses out of the income of a trust that was given to a spouse. Under section 2523(e), in order for a donor to be entitled to a deduction for a gift in trust to his spouse over which the spouse has a general power of appointment, the spouse must be entitled to all of the income from the trust. Under section 25.2523(e)-1(f)(3), Gift Tax Regs., a spouse is considered to receive all of the income from a trust even if "trustees' commissions, and other charges" are paid out of income, provided the spouse is not deprived of substantial beneficial enjoyment. That section is similar to section 20.2056(b)-(5)(f)(3). Estate Tax Regs. In interpreting those sections, respondent has considered the effect of a power

"To charge to income or principal, executor's or trustee's commissions, legal and accounting fees, custodian fees, and similar administration expenses" on the marital deduction. Respondent concluded that such a power "does not result in the disallowance or *diminution* of the marital deduction." Rev. Rul. 69-56, 1969-1 C.B. 224 (emphasis added). While we recognize that the revenue ruling is not binding precedent, it does present respondent's position on this subject. *Crow v. Commissioner* [Dec. 42,339], 85 T.C. 376, 389 (1985).

In the case before us, the power is essentially the same as the power in the revenue ruling. Moreover, the income used to pay administration expenses is insubstantial compared to the lifetime of income Mrs. Hubert will receive from the property. Therefore, she is not deprived of substantial beneficial enjoyment, and she would be treated, under section 25.2523(e)-1(f)(3), Gift Tax Regs., as having received all of the income from the trust. If Mrs. Hubert is treated as having received all of the income from the trust, there can be no material limitation on her right to receive income.

We also reject respondent's interpretation of the legislative history of the marital deduction, which states that *claims* against the estate paid out of income increase the residue by purchase, not bequest, and therefore "the value of any such additional part of the residue passing to the surviving spouse can not be included in the amount of the marital deduction." S. Rept. 1013 (Part II), 80th Cong., 2d Sess. (1948), 1948-1 C.B. 331, 335. The Senate report describes the result only if income is used

to pay *claims against the estate;* it does not discuss administration expenses at any point. There is a clear distinction between claims against the estate and administration expenses which are allocable to income, and this distinction mandates different treatment of the two. Claims against the estate are, by definition, in existence at the date of death; therefore, by their very nature, claims against the estate relate to corpus and must be charged thereto. By contrast, administration expenses come into existence only after the death of the decedent and may relate to both income and corpus. As a result, administration expenses logically can be charged to either income or corpus. Here they were charged to income in accordance with the will and Georgia law. Accordingly, the legislative history cited by respondent does not control the treatment of administration expenses in the case before us.

This Court has spoken on this issue in *Estate of Richardson v. Commissioner* [Dec. 44,388], 89 T.C. 1193 (1987), and *Estate of Street v. Commissioner* [Dec. 45,201(M)], T.C. Memo. 1988-553, affd. in part and revd. in part [92-2 USTC ¶ 60,112], 974 F.2d 723 (6th Cir. 1992). In *Estate of Richardson,* the decedent left to his wife the amount of his residuary estate necessary to maximize all of his estate tax deductions in order to make his estate nontaxable for Federal estate tax purposes. The decedent's executors were given the power to allocate expenses between income and principal. Respondent argued that the marital deduction should be reduced by the amount of interest payable on the estate's Federal estate taxes and State inheritance taxes, even though the executors had allocated the interest to income.

We concluded: "Whether an expenditure on behalf of an estate is chargeable to principal, or the income produced thereby, depends on the law of the State wherein decedent was a resident at the time of his death, or upon the terms of decedent's will." *Estate of Richardson v. Commissioner, supra* at 1201. In that case, there were no provisions of State law dictating where the interest should be charged. Therefore, we looked to the language of the will and determined that, based on the decedent's intent to minimize taxes, the executors had the power to charge the interest against income and, thereby, not reduce the marital deduction.

In *Estate of Street*, on similar facts we held that Tennessee law permitted a decedent to grant the power to allocate administration expenses between income and principal. We held that the marital deduction was not reduced by the amount of the expenses allocated to income.

We note that the fact that the marital bequest in *Estate of Street* was in trust did not affect our reasoning in that case. Respondent argues that the fact of the trust should make a difference, because if Mrs. Hubert is receiving only an income interest and part of the income is used to pay expenses, the value of the interest passing to Mrs. Hubert is reduced. However, respondent ignores the fact that, because Mrs. Hubert has a general power of appointment over one of the trusts and the other trust is a qualified terminable interest trust, Mrs. Hubert is treated as having received the entire value of both trusts, not just the income portions.

On appeal, the Court of Appeals for the Sixth Circuit reversed our holding in *Estate of Street* with regard to administration expenses, concluding that payment of such expenses reduces the marital deduction whether the payment is allocated to income or to principal. However, the court upheld our holding that the payment of interest on estate taxes and inheritance taxes allocated to income does not reduce the marital deduction. *Estate of Street v. Commissioner* [92-2 USTC ¶ 60,112], 974 F.2d 723 (6th Cir. 1992), affg. in part, revg. in part and remanding.[4]

On the issue of the administration expenses, the Court of Appeals determined that section 20.2056(b)-4(a), Estate Tax Regs., was controlling. The Court of Appeals concluded that the regulation mandates a setoff against the marital deduction for administration expenses paid from income. The court reasoned:

> Income earned by the estate during * * * [the administration] period builds up the marital share. Expenses paid from income during this period have the effect of decreasing the amount of estate property distributable to the spouse. Therefore, the payment of administrative expenses from income must operate to reduce the size of the marital deduction, otherwise the spouse would receive a deduction which

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[4] Respondent has now accepted the holding that the payment of interest on estate and inheritance taxes allocated to income does not reduce the marital deduction. Rev. Rul. 93-48, 1993-25 I.R.B. 9. Respondent has specifically limited her change in position to payments of interest and has reaffirmed her position regarding all other administration expenses. As we explain below, we see no valid distinction between interest and other administration expenses.

> exceeded the amount which was actually in the estate, and available for distribution. * * * [*Id.* at 727.]

The court found support for this reasoning in the legislative history of the marital deduction.

The Court of Appeals distinguished administration expenses from interest on estate and inheritance taxes on two grounds. First, citing *Estate of Richardson*, the court stated that the interest on taxes accrues after death, whereas administration expenses "accrue at death." As a result, the court determined that payment of interest on taxes from estate income does not affect the principal of the estate as it existed at the time of decedent's death, but payment of administration expenses from such income "will serve to build up the gross estate." *Id.* at 727. Second, the court noted that section 20.2056(b)-4(a), Estate Tax Regs., specifically mentions administration expenses in its example, but it does not mention interest on taxes. Therefore, the court held that the regulation was inapplicable to interest on taxes. *Id.* at 729. Thus, the Court of Appeals concluded that payment of administration expenses from income of the estate should reduce the marital deduction, but payment of interest on estate and inheritance taxes from income should not reduce the marital deduction. See also *Burke v. United States* [93-1 USTC ¶ 60,132], 994 F.2d 1576 (Fed. Cir. 1993), and *Fisher v. United States*, 28 Fed. Cl. 88, (1993), which rely on the rationale of *Estate of Street* with respect to administration expenses.

Respectfully, we disagree with the reasoning of the Court of Appeals and decline to follow its decision in *Estate of Street*. As stated above, we interpret section

20.2056(b)-4(a), Estate Tax Regs., to be a valuation provision. Therefore, unlike the Court of Appeals, we find that the regulation does not control the case before us. In addition, as noted previously, we conclude that the legislative history of the marital deduction does not mandate a different conclusion.

Moreover, we take issue with the Court of Appeals' analysis of the effect of income and expenses on the marital share. The court stated that income earned on estate property increases the marital share, and presumably the marital deduction, leading to a deduction greater than the amount distributed if payment of expenses from income does not reduce the marital deduction. However, income earned on estate property is not included in the gross estate. *Alston v. United States* [65-2 USTC ¶ 12,339], 349 F.2d 87 (5th Cir. 1965). As a result, under section 2056(a), such income does not lead to an increase in the amount of the marital deduction requiring a corresponding decrease for payment of administration expenses chargeable against income of the estate.

Finally, we disagree with the Court of Appeals' distinction between interest on estate and inheritance taxes and administration expenses. The fact that section 20.2056(b)-4(a), Estate Tax Regs., explicitly refers to administration expenses but does not mention interest on taxes is not relevant because the reference to administration expenses is "*An* example of a case in which this rule *may* be applied". Sec. 20.2056(b)-4(a), Estate Tax Regs. (emphasis added). Application of the regulation, when appropriate, is clearly not limited to administration expenses. Regardless of the regulation's treatment of

administration expenses and interest on taxes, it does not provide a useful distinction between the two.

In addition, administration expenses and interest on taxes cannot be distinguished according to the time at which they accrue. Both accrue after the date of death. Administration expenses, by their very nature, are incurred over the entire period of the estate's administration and can vary significantly from estate to estate. As a result, administration expenses are too uncertain at the date of death to accrue at that time. Our analysis in *Estate of Richardson v. Commissioner* [Dec. 44,388], 89 T.C. 1193 (1987), therefore applies to administration expenses as well as to interest on taxes, and we will follow our holding in that case.

Both respondent and the Court of Appeals cite *Estate of Roney v. Commissioner* [Dec. 24,026], 33 T.C. 801, (1960), affd. [61-2 USTC ¶ 12,040], 294 F.2d 774 (5th Cir. 1961), as support for their positions. In *Estate of Roney,* the decedent left the residue of his estate to his wife. The will made no provision as to the source for payment of administration expenses. The executor deducted the administration expenses on the estate's fiduciary income tax returns and did not reduce the marital deduction on the estate tax return by the amount of those expenses. In that case, we looked to Florida law and determined that the executor was required to pay administration expenses out of the residuary estate. Since the residuary estate does not include income, we determined that the marital deduction should be reduced by the amount of the expenses because the amount of principal received by the spouse was reduced to that extent.

The holding in *Estate of Roney* is not inconsistent with the result we reach in the case before us. We merely held in *Estate of Roney* that when administration expenses are required to be allocated to principal, the marital deductions is reduced by the amount of those expenses. Whether the deduction for the administration expenses is taken on Form 706 or Form 1041 is immaterial and irrelevant. See also *Alston v. United States, supra.*

Although *Estate of Wycoff v. Commissioner* [Dec. 31,831], 59 T.C. 617 (1973), aff'd. [74-2 USTC ¶ 13,037], 506 F.2d 1144 (10th Cir. 1974), was not cited by either party, we find it appropriate to discuss that case here. In *Estate of Wycoff,* the decedent's will provided:

> all inheritance, estate and transfer taxes due by reason of my death shall be paid out of that portion of my estate which is not included in the Marital Trust to be administered by my Trustee, unless, in the best business judgment and sole discretion of my executor, such taxes could be more prudently paid from any assets in my estate without respect to what is or is not included in the Marital Trust * * * [*Id.* at 619.]

Based upon the above election available to the executor, we concluded that the marital trust might be charged with those taxes and that the marital deduction was accordingly reduced. We distinguish that case on its facts.

The executor's choices in *Estate of Wycoff* were between two shares of the estate, the marital trust and the nonmarital trust, both of which were included in the gross estate, and not between principal and income, where only principal would be included in the gross

estate and income would be accounted for and taxed separately, as noted above.

We decline to read *Estate of Wycoff* more broadly to make the result depend entirely on the discretion of the executor. We will confine *Estate of Wycoff* to its facts and to the more narrow interpretation which we believe was intended by the Court.

Respondent cites Ga. Code Ann. section 53-2-101 (Michie 1982) as support for the contention that Georgia law requires expenses to be allocated to principal rather than income. However, that section only requires allocation of expenses to the principal if no other provisions are made by the will. Ga. Code Ann, section 53-15-3 (Michie 1982) allows decedents to grant their executors the power to allocate expenses between principal and income. Decedent, in this case, clearly granted such power to his executors.

Finally, we conclude that the settlement agreement did not alter decedent's grant of the power to allocate expenses. The settlement agreement merely set forth a formula for determining the final amounts of both income and principal to be received by Mrs. Hubert and the charity. That this is the case is demonstrated by the fact that both parties agree the marital portion, as calculated under the settlement agreement, should be reduced by income in order to determine the marital deduction. The fact that the settlement agreement provided for allocation of expenses between the marital and charitable portions does not preclude the executors from allocating those expenses to income rather than principal within those portions pursuant to the 1982 will.

Respondent cites a variety of cases in support of the contention that the marital and charitable deductions must be reduced by expenses. However, none of those cases is on point. They deal with situations in which the will made no provision for the allocation of expenses and, therefore, the statute controlled the allocation. Here, we clearly have a provision in the will which controls the allocation.

We hold that the allocation of petitioner's expenses to income was permitted by Georgia law, and the marital and charitable deductions are not reduced by expenses so allocated.

Imputed Income

The third issue we must decide is whether the marital and charitable portions must be discounted by 7 percent per annum to take into account income deemed to be earned by the residue.

The parties agree that the amounts of the marital and charitable deductions should be based on the date-of-death value of the residue. The parties also agree that the marital and charitable portions as determined by the settlement agreement must be reduced by accumulated income included in those portions to arrive at the date-of-death value of the principal which will constitute the deductible amounts. The parties disagree about the amount that should be subtracted as income. Petitioner contends that actual income figures should be used. Respondent argues that an imputed figure of 7 percent per annum should be used. We agree with petitioner.

Respondent argues that Georgia law requires us to impute income of 7 percent per annum to the marital and charitable portions and determine the deductions in that manner. Respondent relies on Ga. Code Ann. section 53-2-97 (Michie 1982), which states: "A general legacy usually bears interest after the expiration of 12 months from the death of the testator", and Ga. Code Ann. section 7-4-2 (Michie 1982), which established 7 percent per annum as the legal rate of interest where an interest rate is not established, as support for the imputed income argument. However, those sections are not controlling.

In this case, we are not charged with the task of determining the amounts of income the marital and charitable shares were required to receive. We are charged with determining what amount of the residue went to deductible administration expenses and marital and charitable bequests. In making that determination, we must look to the residue at the date of death. *Jackson v. United States* [64-1 USTC ¶ 12,221], 376 U.S. 503, 508 (1964).

At the time of decedent's death, the amount of the residue was a definitely determinable amount. Under the settlement agreement, that amount was divided among the marital and charitable portions, which included income to the date of settlement, and the administration expenses. Despite the agreement's complex language and respondent's contention that the agreement is much more complex, the result is, in fact, very simple. The entire residue is divided among three deductible portions, making the entire residue deductible no matter how much income was or should have been earned later.

The value of the corpus at the date of death is the value used in determining the deductions. Any use of income figures is merely to determine the amount of income allocated to each of the portions; for that determination, it is appropriate to use actual income figures. For our purposes, however, that determination is irrelevant, since the corpus allocated to each of the portions is deductible.

We hold that the marital and charitable portions should not be discounted 7 percent per annum for income deemed to be earned by the residue in order to arrive at the marital and charitable deductions. Date-of-death values should be used. If the parties need income figures for purposes of the Rule 155 computation, actual income figures should be used.

Decision will be entered under Rule 155.

Reviewed by the Court.

PARKER, SHIELDS, COHEN, SWIFT, JACOBS, GERBER, WRIGHT, PARR, WELLS, RUWE, WHALEN, COLVIN, CHIECHI, and LARO, JJ., agree with the majority opinion.

HAMBLEN, C.J., did not participate in the consideration of this opinion.

"APPENDIX B"

[¶ 12,944] *Estate of Frances Blow Allen, Deceased, Bank of Oklahoma, N.A. and R. Robert Huff, Co-Executors, Petitioner v. Commissioner,* CCH Dec. 49,346, 101 T.C. –, No. 23, October 20, 1993, Dkt. No. 309-91, opinion by Judge Tannenwald. [Appealable, barring stipulation to the contrary, to CA-10. – CCH.]

[*Code Sec. 2056*]

Estate tax: Martial deduction: Interest passing to surviving spouse: Administration expenses. – An estate was not required to reduce the marital share of a decedent's residuary trust by the amount of the estate's administration expenses in computing the estate's marital deduction where the income of the estate attributable to the nonmarital share of the trust was more than sufficient to absorb the administration expenses. The marital deduction was not reduced because of applicable state (Oklahoma) law mandated that, in the absence of any direction to the contrary in the decedent's will, administration expenses were to be charged to income. In addition, the provisions of the will and state law mandated that the marital deduction be maximized. Further, Reg. § 20.2056(b)-4(a) was not applicable because there was no "material limitation" upon the right of the surviving spouse to the income of the marital share where there was no direction nor other requirement that the income of the marital share of the trust be used to pay the administration expenses.

The decedent, a resident of Oklahoma, died testate in 1987. The decedent's will provided that the residue of her

estate was to fund a credit shelter trust and a marital trust for her husband. The credit shelter trust was to consist of so much of the residuary estate as would equal the federal estate tax unified credit in effect for the year of her death. The residue not required to fund the credit shelter trust was to fund the marital trust. The will stated that it was the decedent's intent that the whole of the marital trust shall qualify for the unlimited marital deduction.

The net income of both the marital and credit shelter trust was to be paid to the decedent's husband at least annually. On the death of the husband, the remaining corpus of the marital trust and the income from the period between the last distribution date and the date of the husband's death was to be added to the principal of the credit shelter trust. Upon the death of the husband, the credit shelter trust was to be disposed of for the benefit of the decedent's issue. In addition, the terms of the decedent's will directed the executors to pay all death taxes out of the credit shelter trust, as an expense of administration. Further, the trustees were given all powers, duties, and responsibilities authorized by the Oklahoma Trust Act. The executors were empowered to exercise their sole discretion as to whether to claim items either as income tax deductions or as death tax deductions, without making any adjustments as between income and principal of any trust or as between any beneficiaries by reason thereof.

The co-executors charged the administration expenses totaling $119,650 to the income generated by the estate and made an irrevocable election under Code Sec.

642(g) to deduct the expenses on the fiduciary income tax returns.

The sole issue before the Tax Court was whether administration expenses should reduce the amount of the marital deduction. The estate argued that the provisions of the decedent's will and Oklahoma Law mandated that the administration expenses be charged to income and, therefore, that Code Sec. 2056 and Reg. § 20.2056(b)-4(a) did not require the amount of the marital trust to be reduced by those expenses. In addition, the estate urged that the Tax Court to adhere to its position in *G. Street Est.*, 56 TCM 774, CCH Dec. 45,201(M), TC Memo. 1988-553, notwithstanding the reversal of that case by the U.S. Court of Appeals for the Sixth Circuit (*G. Street Est.*, CA-6, 92-2 USTC ¶ 60,112, 974 F2d 723). In the alternative, the estate argued that the decision of the Sixth Circuit in *Street* was factually distinguishable.

The IRS, on the other hand, asserted that the applicable estate tax statute and regulations required that the marital trust be reduced by the amount of the administration expenses in order to arrive at the allowable amount of the marital deduction.

The court held that the marital trust did not have to be reduced by the amount of the administration expenses. In so holding, the court determined that the instant case fell within the ambit of the decided cases where the marital deduction was not reduced by the amount of death taxes or administration expenses because it was clear that, under the provisions of the will and state law, such items were to be charged to the nonmarital share and not to the principal or income of the marital share.

This was so because Oklahoma law mandated that, in the absence of any direction to the contrary in the decedent's will, administration expenses were to be charged to income. In addition, the provisions of the will and state law mandated that the marital deduction be maximized. Further, the court concluded that Reg. § 20.2056(b)-4(a) was not controlling because there was no "material limitation" upon the right of the surviving spouse to the income of the marital trust where there was no direction nor other requirement that the income of the marital trust be used to pay the administration expenses.

The court distinguished the facts in the instant case from *Street*, because *Street* involved a single marital trust of the entire residue estate, whereas, in the instant case, the residue was divided into a marital and a nonmarital trust. Moreover, the estate income of the nonmarital credit shelter trust in the instant case was more than adequate to cover the administration expenses. **Back references: ¶ 7565.674 and 7565.73.**